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Struggling for survival and revival in the Portuguese Construction Sector: Need for Strategic Reorientation

Francisco José Alves Barbêdo Melo Marques

2810

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Professor Doutor José Álvaro Ferreira da Silva

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Abstract

The construction sector in Portugal declined sharply over the past 10 years. The current crisis can wiped out the entire industry. Can the industry survive? What lessons can we learn? What can be done to revive the sector? These are questions this study intends to answer. By analyzing the best practices of the industry and of the largest construction companies in Portugal, as well as the difficulties and constrains that they all faced, I found that retrenchment (operational costs and selling assets) are the main measures companies resort to, and that strategic reorientation is essential to turnaround. I found that internationalization is a key driver on strategic reorientation and diversification and concentration are complementary strategies that can enforce and strengthen the main one.

Keywords: Crisis, Construction, Turnaround, Retrenchment, Internationalization, Diversification, Concentration

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1 – Introduction

The current global financial crisis provides a call for restructuring and cost cutting. But cutting back and hunkering down may get firms through the short term crisis but will not position them to the future. Managers must repositioning and lead firms and industry not just through the crisis but also redefine how business will be conducted in the long run.

The aim of this study is to bring a comprehensive overview of firm strategy in the context of recessionary environments and structural breaks, focusing on the Portuguese construction sector. In fact, despite the episodic pervasiveness of recessions and their destructive impact on firms, very little sectoral research has addressed how managers from construction firms can successfully navigate these treacherous events.

The first section synthesizes the lessons available for business turnarounds in previous recessionary environments and summarizes the most common and successful recovery strategies. Then a new section give us a quick snapshot of the Portuguese construction sector over the last years and its current situation as well as its future prospects. Another section analyzes the best practices of the industry and of the largest construction companies in Portugal, its difficulties and its constrains over the last decade. Strategic reorientation (internationalization, concentration and diversification) and retrenchment (namely financial restructuring) are key aspects this study identify as essential to firms overcome crisis and achieve turnaround. Each of these features is analyzed individually in specific sections.

This study intends to make a contribution to a better understanding of how managers can make survive and revive an entire industry that can be wiped out if nothing changes.

2 - Business turnaround in periods of crisis: a literature review

Economic recessions represent the most transformative event faced by organizations. Research has demonstrated that recessions dramatically transform and many times wipe out industry landscapes. Prior studies consistently identify five effective turnaround strategies that helped firms make a sustained recovery in the past: Cost efficiencies measures (Cost cutting and financial restructuring); Asset retrenchment measures; Focusing on core activities; Strategy reorientation; Leadership and culture change.

Cost efficiencies measures (Cost cutting and financial restructuring)

Cost efficiency measures are considered indispensible in achieving turnaround and are almost the first step in any recovery strategy. They can be quickly implemented, may have an almost immediate effect, and generally require little or no capital/resource investment (Hofer, 1980; Robbins and Pearce, 1992).

The aim is to stabilize finances in the short-term until more complex strategies are built, or to quickly improve cash flow (Bibeault, 1982; Hambrick and Schecter, 1983; Sudarsanam and Lai, 2001).

Cost efficiencies commonly reported in the literature include reducing R&D, collecting and reducing accounts receivable, cutting inventory, stretching accounts payable, reducing marketing activity, eliminating pay increases, reducing other selling, general, and administrative expenses (SGA), adjusting wage incentives, tighter stock control, encourage greater efficiencies and simplify processes.

These were frequently accompanied by financial restructuring such as a reworking of the capital structure so as to relieve pressure from debt repayments and interest expenses.

All these cost cutting measures should not be blind and should be reconsidered after a suitable length of time, so as not to damage assets or resources and to keep employee commitment at high levels. Indeed some studies present evidence that firms which were unsuccessful in their turnaround efforts over-pursued cost efficiencies (Boyne and Meier, 2009). Similarly, cutting R&D costs alone is unlikely to be a major contributor to turnaround and, furthermore, may weaken the firm for the future.

Asset retrenchment measures

Asset retrenchment is the natural second step following cost efficiencies (Robbins and Pearce, 1992). Asset retrenchment refers to closing plants, divesting equity (sell / spin - offs, and equity carve-outs), and reducing stocks of property, equipment, and inventory.

Business areas that are underperforming are evaluated to determine if efficiencies can be achieved, or whether it is best to divest the asset completely (Hofer 1980; Morrow et al., 2007). Many times the rationality behind asset retrenchment is survival and the need to stem the bleeding (Gopinath, 1991), compromising many times future strategic options.

The success of asset retrenchment as a component of a turnaround strategy depends on the firm’s ability to generate cash flow from any disposal. Difficulties surrounding disposal and cash generation may arise due to asset specificity, market liquidity, fire sale pressure and exit barriers (Filatotchev and Toms, 2006).

Pearce and Robbins (1993) argued that managers should choose between cost and asset retrenchment contingent upon the severity of the decline. That is, more severe situations call for asset reductions in the retrenchment phase, while less severe situations may be stabilized by cost retrenchment alone. In fact, many times retrenchment is viewed as a consequence of a steep performance decline, suggesting that it is an activity that managers are more or less forced into when internal firm resources become extremely restricted (Whetten, 1987; Cameron et al, 1988). As such, firms facing turnaround situations will have several levels of pressure to retrench depending on the severity of their performance decline.

Focusing on core activities

Closely related to asset retrenchment is the strategy of focusing in core activities. This strategy implies determining the markets, products and customers that have the potential to generate the greatest profits and refocusing the firms activities on these areas. Focus allows the firm to develop a clear competitive strategy in its chosen core activities. (Boyne and Meier 2009; Robbins and Pearce, 1992; Robbins and Pearce, 1993).

Strategy reorientation

Many times strategy reorientation is linked only with a recovery phase of the turnaround process (Filatotchev and Toms, 2006; Robbins and Pearce, 1992). As such, retrenchment is viewed as the prerequisite for turnaround. But retrenchment can miss the strategic core of the problems. Strategy reorientation it is about positioning for long-term growth rather than short-term day-to-day survival, and these issues can be addressed at any moment. Despite the severe nature of their decline, companies should be very much concerned with implementing a suitable strategic reorientation in the course of their path.

Recovery activities refer to strategic changes that transform and reposition the firm for sustained growth and profitability. These activities include market penetration, product launch, market entry, acquisitions, product-market scope alterations, structure and control systems changes, diversification and repositioning, structural change, and so forth (Bibeault, 1982; Robbins and Pearce, 1992).

While retrenchment focuses on increasing efficiency through cost and asset reductions, recovery concentrates on improving a firm’s market position through strategic change. Since research describes retrenchment and recovery as contradictory forces (Pearce and Robbins, 2008), turnaround firms should opt for one or the other (Hofer, 1980), or to address them sequentially (Robbins and Pearce, 1992).

Leadership and culture change

CEO change and replacement of part or all of the top management team is significantly linked to firms in distress and can serve as a signal of change to external audience and internally to the employees (Daily and Dalton, 1995). Further, companies have a greater capacity for strategic change when CEOs are replaced since new leaders are more likely to break the "old rules" and to be less committed to past policies. It is often identified as a pre-condition for culture change and for almost all successful turnarounds (Hofer, 1980).

3 – The Portuguese Construction Sector: an overview

In the next pages it will be given a quick snapshot of the Portuguese Construction Sector over the last years and its current situation as well its future prospects:

- The contribution to the economy is best measured by its gross value added (GVA). In 2013 the construction sector accounted for 4.3% of Portuguese GVA, half of what represented in 2000. In the last thirteen years, while the economy GVA grew at an average annual rate of 0,35%, the GVA of the construction sector decreased at an average annual rate of more than 5,2%. Since 2001 the sector has recorded successive falls, especially after the financial crisis of 2008. **Appendix 2.**
- The construction sector employed in 2013 more than 320 thousand people, representing 6,5% of employment in the economy, compared to 12% in 2000. In the last thirteen years, the sector has lost about 300 thousand jobs, registering a negative average annual growth rate of 5%. Since the 2008 crisis, the sector recorded a loss of more than 230 thousand people, of which more than 140 thousand on last 2 years. **Appendix 3.**
- In 2012, the construction sector was one of the economic activities that concentrated the highest number of unemployed. Over the past five years the unemployed in the construction sector grew at an average annual rate of over 25%, and the rise has accelerated sharply in the last two years. **Appendix 4.**
- In 2013 the domestic investment in the construction sector was about 40% of the value recorded in 2000 (11,3 against 26,6 thousand million €). Representing about two-thirds of investment in the economy in 2000, the investment in the construction sector decreased at an average rate of over 6% in the last thirteen years and more than 10% in the last five, representing now less than 50% of total domestic investment. **Appendix 5.**
- In 2013, Portugal was the 21th EU country in terms of contribution of the construction sector to the Gross Value Added (Table 1), with a share of 4,3%, while in 2000 it was the 2nd with a value of 9,1%, second only to Spain. In terms of employment the situation is not so reversed, with the sector representing 6,5% of employment in 2013, ranking the 7th place of the table of EU countries - in 2000 was 1st with 12%.

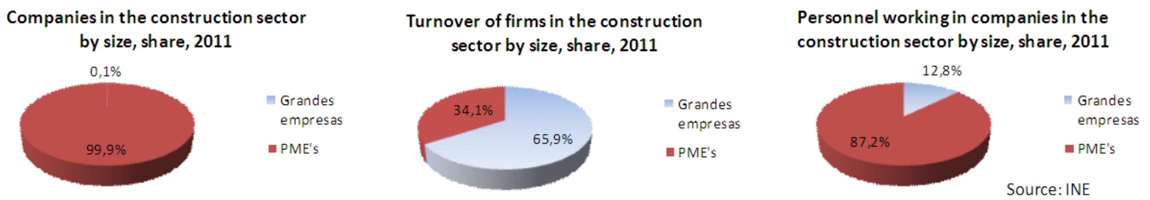
Table 1 - EU Ranking: Gross Value Added and Employment (Building & construction as % of total)

Gross value added at current prices: building and construction as % of total									
Country	**2000**	**Rank**	**2005**	**Rank**	**2010**	**Rank**	**2013**	**Rank**	
Spain	10,3%	1	13,6%	1	10,7%	1	7,8%	2	
Portugal	**9,1%**	**2**	**7,6%**	**7**	**5,8%**	**17**	**4,3%**	**21**	
Cyprus	8,8%	3	11,0%	2	8,9%	4	4,0%	24	
Employment, persons: building and construction as % of total									
Country	**2000**	**Rank**	**2005**	**Rank**	**2010**	**Rank**	**2013 a)**	**Rank**	
Portugal	11,9%	1	10,8%	2	10,3%	1	6,5%	7	
Spain	9,6%	2	11,1%	1	7,9%	4	5,8%	15	a)
Luxembourg	9,2%	3	10,1%	4	10,0%	2	9,7%	1	

Source: AMECO *a) year 2012*

- According to Coface (a worldwide leader in credit insurance), in 2012, the construction sector, which weighed about 8% in companies established in Portugal, concentrated 20% of the shares of insolvency in the country (the sector with the highest weight in total).
- The construction sector in Portugal, as in other EU countries, is traditionally based on a business structure with small businesses (Figure 1) and often resorting to subcontracting schemes. On the other hand, there is a group of larger firms despite representing only 0.1% of companies in the sector and less than 13% of all staff, accounted for over a third of the turnover of companies in the construction sector.

Figure 1 - Construction sector by size (2011)



Source: INE

- The main thread in the construction sector, which accounts for 60% of employment in the sector, is the residential market, the segment most affected by global economic crisis (-44% decrease between 2010/12). There is also an oversupply in this segment. Construction of non-residential buildings, mainly of private nature, particularly in segments of Commerce, Industry and Tourism, was also very affected (-41% between 2010/12). Civil Engineering Works are very linked with the public investment that suffered a sharp reduction (more than 20% between 2010/12) due to financial constrains of the public sector. **Appendix 6.**

4 - Portuguese recovery strategies

Despite strongly aggravated by the current financial crisis, the situation of the Construction sector is the result of a deep and prolonged recession starting in 2000. During this long period crisis, construction sector did not restructured itself, but reduced investments, reduced margins, indebted up, decapitalized itself, and faced financial difficulties induced by the credit constraints from both clients (individuals, businesses and state) and construction firms, by shrinking margins and by payment delays. The majority of companies retained employment till 2008, hoping to seize the long-awaited recovery in the sector, that never happened. After 2008 the drop in employment was sharp and destructive. A new strategic orientation for the sector is required.

The review of the best practices of the industry and of the largest construction companies in Portugal: Mota-Engil (ME), Teixeira Duarte (TD), Soares da Costa (SdC), Elevo Fund (Elevo), as well as the difficulties and constrains that they all have faced, provide clues and some answers to find strategic priorities/axis that may guide the strategic reorientation of the construction sector in Portugal: **Diversification**; **Internationalization**; and **Concentration**. But this study also focuses the main measures and tactics companies can resort to before any successful turnaround: **Retrenchment measures** (financial Restructuration, asset retrenchment, operating efficiency). These measures, due to the financial weakness of the entire sector in Portugal, have proven to be of enormous importance to this work and for the proper understanding of the turnaround process in Portuguese firms. The consistency of the Portuguese practices and the findings in the literature review will also be analyzed.

According to information from the data base for the Bank Accounts of Companies Harmonized (BACH-www.bach.banque-france.fr), summarized in table 2, on average, large Portuguese companies in the construction sector compare favorably with their European counterparts (2012) regarding margin arising from its operating activities (per each € of turnover is generated 15 cents of EBITDA). However, the return on equity is lower than in most other countries (Portugal 5,3% and Spain -15,6% with the worse returns), a situation that is due in large measure to the financing structure, characterized by low financial autonomy and high dependence on debt capital, particularly for loans with credit institutions. These findings are the starting point for the analysis described below.

Table 2 - European construction companies comparative results

	Financing Ratios on Large Companies (2012)				
	Weight of Bank Loans on Assets	Financial Autonomy	EBITDA over Turnover	Return on Equity	Financial pressure
Belgium	5,3%	70,0%	8,2%	2,7%	9,8%
Czech Republic	2,2%	40,3%	6,0%	8,2%	N.A.
Austria	11,5%	28,1%	8,3%	8,1%	18,9%
Poland	21,6%	22,9%	3,9%	11,9%	26,2%
Italy	18,6%	20,9%	10,2%	7,9%	19,9%
Germany	6,6%	17,6%	7,1%	18,2%	13,9%
France	6,7%	16,1%	4,4%	21,5%	11,2%
Spain	38,1%	12,1%	11,9%	-15,6%	51,2%
Portugal	25,8%	22,4%	15,3%	5,3%	39,5%
Evolution (base 100 = 2008)					
Portugal			184,9	89,3	111,9
BACH Average			102,8	132,9	94,6

Source: Bank for the Account of Companies Harmonized (BACH), www.bach.banque-france.fr

4.1. – Retrenchment: Operational costs and selling assets

In a crisis the priority is to generate cash flow (Bibeault, 1982; Hambrick and Schecter, 1983; Sudarsanam and Lai, 2001) in order to compensate and pay off the enormous debt, meaning that there is no scope for developing other strategies that involves capital. In Portugal, the operational efficiencies gains and the reducing on operating costs (Table 3) has been achieved at the expense of lower costs on external service supplies ("FSE" Portuguese accounting). This sector lives much on the basis of subcontracting, so unlike other sectors, is relatively easy to reduce costs without resorting to layoffs (micro and small enterprises were those that suffered such consequences) and force increases in productivity within the company. The higher the company the higher is the proportion of the company "FSE" on operational costs (66% in large companies). Personnel costs only fall after 2012 on large companies when it was no longer possible to avoid the breaking of the activity and companies began to lay off. However in large companies relocating employees to other geographies prevented the intensive use of such measures.

Table 3 - Operational Costs in the Construction sector

	Annual growth rate (%) and contributions (b.p.)					Operarting activity structure (2012)		
	2008	2009	2010	2011	2012	Construction Sector	Small and Medium	Large Companies
Operating costs (growth rate)	3,8%	-8,2%	0,2%	-12,6%	-26,3%	100,0%	100,0%	100,0%
Materials and Consumptions	-1,3	-5,5	-1,9	-3,6	-6,8	25,3%	26,2%	18,2%
External supplies / services	3,9	-1,8	2,9	-7,6	-16,0	52,5%	47,8%	66,0%
Personnel Costs	1,2	-0,9	-0,8	-1,4	-3,5	22,2%	26,0%	15,9%

Source: Banco de Portugal

Table 4 – ME: Operational Costs

€ Millions	Mota-Engil			
	2013	2012	2011	2010
Number of Workers	28 345	26 161	20 653	19 404
Variation (%)	8,3%	26,7%	6,4%	
Europe	7 550	9 395	7 758	8 123
Africa	14 359	9 709	11 119	5 221
America	6 007	6 616		
Other & Holding	429	441	1 776	6 060
Operating Costs	2 013	2 026	1 964	1 875
Variation (%)	-0,6%	3,2%	4,7%	
Operating Costs Structure	100,0%	100,0%	100,0%	100,0%
Materials and Consumptions	21,0%	24,8%	23,1%	17,7%
External supplies / services	56,8%	54,7%	57,9%	63,2%
Subcontracts	31,9%	31,8%	36,7%	45,0%
Europe	6,7%	19,6%	29,2%	35,9%
Other Regions	25,1%	12,2%	7,5%	9,2%
Personnel Costs	22,2%	20,6%	19,0%	19,1%
Europe	8,7%	10,8%	10,8%	16,8%
Other Regions	13,5%	9,8%	8,2%	2,3%

Source: Report and accounts 2009-2013

Table 5 – ME: Tangible assets & investments

€ Millions	Mota-Engil			
	2013	2012	2011	2010
Tangible Assets	691	613	565	569
Variation (%)	12,6%	8,7%	-0,8%	
Land & Building	261	248	234	226
Equipment	375	338	309	310
Europe	48,4%	78,3%	79,4%	80,8%
Africa	42,0%	15,2%	14,3%	15,2%
America	9,3%	6,1%	5,5%	3,3%
Other & Eliminations	0,2%	0,4%	0,7%	0,7%
Other Investments	323	324	285	446
Variation (%)	-0,3%	13,7%	-36,1%	
Investments Properties	55	66	63	89
Financial Investments (Equity Method)	218	219	217	337
Available For Sale Financial Assets	50	39	5	21

Source: Report and accounts 2009-2013

Mota-Engil is a very good example of these peculiarities. The strategy of Mota-Engil has been to mobilize equipment and employees to other geographic areas where activity was increasing and reallocate resources in anticipation of the expected slowdown of activity in Portugal and with the objective of resource optimization. In general, operational costs, number of workers and assets are increasing, but at the same time the international mobility and the reduction of subcontracts is notorious (between 2010 and 2013: 7% fall on the number of workers in Europe and 84% rise in other external markets; 80% fall in subcontracts costs in Europe; 28% fall in equipment in Europe in contrast with the 226% rise in other external markets). Table 4 and 5 summarizes these results (**appendix 7 and 8** for information on other companies).

EBITDA margins (Table 6) are at the level of the best in class within the global construction industry (2013: ME 15,7%, TD 13,5%). Teixeira-Duarte in a movement of market anticipation and great intuition, sold in 2010 its 22,17% stake in Cimpor to Camargo Corrêa by 968,4 Million, which allowed TD to significantly lower its debt (about -45%) and ensure several degrees of freedom on its operations during the financial crisis in Portugal.

Table 6 – Financial Ratios

	Mota-Engil				Soares Da Costa			
	2013	2012	2011	2010	2013 a)	2012	2011	2010
EBITDA Margin (EBITDA/Turnover)	15,7%	12,8%	13,6%	11,8%	27,6%	9,0%	10,8%	9,9%
Return on Equity (ROE)	15,8%	17,0%	33,1%	14,4%	-149,7%	-89,3%	2,0%	11,5%
Financial Autonomy (Equity/Assets)	14,8%	12,1%	6,1%	13,9%	3,5%	3,0%	6,6%	8,4%
Debt Ratio	85,2%	87,9%	93,9%	86,1%	96,5%	97,0%	93,4%	91,6%
Debt Equity Ratio	5,7	7,3	15,4	6,2	27,6	32,7	14,1	10,9
Net Debt / EBITDA	2,7	3,0	3,4	4,3	19,0	14,2	9,2	8,3
Financial Pressure (Interest/EBITDA)	28,7%	30,1%	27,5%	25,4%	120,4%	107,1%	59,1%	52,7%

	Teixeira Duarte				
	2013	2012	2011	2010	2009
EBITDA Margin (EBITDA/Turnover)	13,5%	15,1%	9,8%	10,9%	16,1%
Return on Equity (ROE)	17,9%	8,0%	-65,4%	7,0%	22,3%
Financial Autonomy (Equity/Assets)	13,0%	11,8%	12,1%	20,7%	14,7%
Debt Ratio	87,0%	88,2%	87,9%	79,3%	85,3%
Debt Equity Ratio	6,7	7,5	7,3	3,8	5,8
Net Debt / EBITDA	5,5	4,7	7,9	7,1	9,4
Financial Pressure (Interest/EBITDA)	42,0%	37,4%	63,7%	38,5%	33,1%

Source: Report and accounts 2009-2013

a) On 2013 Grupo SdC accounts, the construction sector is classified as asset held for sale and as discontinued activity

Soares da Costa resized the structure in Portugal in order to adjust to the decreasing turnover in this market. Within this scope, emphasizes the reduction of its personnel structure (988 workers between 2010 and 2012) and fusion of several subsidiaries. Staff costs are still influenced by labour contracts terminations costs on SdC. There was a clear refocusing on the core activities of the company. Non core equity and participations, investment properties and other assets were now divested (a movement in the opposite direction of 2011-2013 strategy of higher diversification). But all these measures were not sufficient to stop the bleeding.

Soares da Costa already in 2014 sold the US construction business to focus all interests in the area of construction exclusively in the minority position in SdC Construção (since Feb

2014 after partnership with GAM, Soares da Costa sold 2/3 of this construction company), and possibly in a few years Grupo Soares da Costa will eventually abandon completely the construction business.

4.2. – Retrenchment: need for financial restructuring

The return on equity of construction (Table 7) has been negative last years and is typically lower than other NF (Non Financial) sectors. Due to the registration of consecutive negative results, 24.7% of construction companies have a negative equity in 2012, but only 6.7% of large companies were in that situation. In fact, the equity return in large firms is positive (5.3%) although below the European, but even in large firms the situation is very dispar (Table 6), with companies like ME and TD with higher ROE (2013: 15,8% and 17,9% respectively) and others like SdC with negative ROE (-149,7% in 2013).

Table 7 - Return on Equity

	Return on Equity					Return on Equity by size (2012)			Number of companies with negative Equity in 2012 (%)			
	2008	2009	2010	2011	2012	Micro	Small and Medium	Large Companies	2012	Micro	Small and Medium	Large Companies
Non Financial Sector	4,5%	4,0%	9,4%	2,8%	-0,5%				29,2%			
Construction	-2,0%	-0,3%	3,3%	-9,0%	-8,4%	-16,1%	-9,4%	5,3%	24,7%	26,8%	9,4%	6,7%

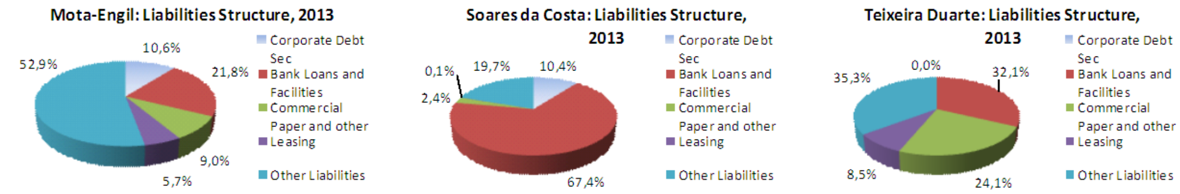
Source: Banco de Portugal

The typical financing structure is not much different from the other NF sectors and is characterized by high undercapitalization and low financing autonomy ratios (about 20% against 30% of NF sectors – **Appendix 9A**; 2013: ME 14,8%, TD 13,0%, SdC 3,5% - Table 6). Mota-Engil has a debt equity ratio of 5,7, which is below its Portuguese competitors but still very high. This is a indicator of high leverage for the Portuguese companies.

The debt capital plays an important role in financing the construction activity, situation that justifies a more detailed analysis of its features and its recent evolution. In fact, in recent years, companies in the construction sector show that they are very dependent on borrowed capital. The main sources of financing has been the financial debt and trade credits (76% of total in 2012). In the area of financial debt, bank loans were particularly relevant (38% of liabilities in 2012), especially in the segment of "building construction" (42% of liabilities in

2012) and the class of Small and Medium Size firms (44% of liabilities in 2012). The indebtedness grew till 2010, but the negative trend in activity in the last decade, especially in the last three years, resulted in significant reductions in bank loans (-20% in 2012) and trade credits (-22% in 2012). The financing by group companies, by contrast, have grown (+8,6% in 2012). **Appendix 9A/B.** This general analysis is confirmed by similar results on individual large firms:

Figure 2 – Liabilty Structure



The class of "Other Liabilities" includes State and related debts, debts to shareholders and members (unpaid), other current liabilities and other payables.

Source: Report and accounts 2009-2013

The high amount of capital required and the substantial time lag that occurs between the time of award and payment (specially with state and local authorities) means that companies often have a need to borrow large bank credits that are responsible for their shrinking margins (in the form of bank interest and guarantee fees). Credit institutions (CI) in Portugal traditionally have a high exposure to the construction sector, but between 2009 and 2012, the loans granted by the CI sector dropped 25.2% (double of the NF sectors). In fact, the financial sector has huge impairments related to credit to the construction sector. More and more construction companies are in default situation (about 44% of companies) and with increasing overdue loans ratios (23.7% in 2012). **Appendix 10 / 11.**

The average financial pressure (weight of interest in EBITDA) of the sector is historically high (Table 8). EBITDA generated in the last three years (2011-2013) was not enough to cover the interest costs for businesses. The sector is no longer able to generate income to cope the cost of financing. Soares da Costa is a good example of this situation, in fact, in general terms and taking into consideration the company's dimension and structure, is noticeable that the level of activity was below the minimum threshold to the extraction of positive profitability. Furthermore, the effect of the financial constrains and financial pressure (107% in 2012) disturbed the operational and commercial activity effectiveness. Mota-Engil (28,7%) and Teixeira Duarte (42,0%) are in the line with the average financial pressure ratio of large companies (Table 6).

Table 8 - Financial Pressure and Solvability

Interest Paid	Non Financial Sector	Construction	Large Companies
Weight of the interest paid on EBITDA (Financial Pressure)			
2008	26,5%	58,8%	
2009	22,7%	47,3%	
2010	16,3%	44,2%	
2011	28,2%	132,3%	
2012	37,2%	133,3%	39,5%
Number of firms with EBIDTA < Interest Paid (%)			
2012	41,0%	43,3%	21,7%

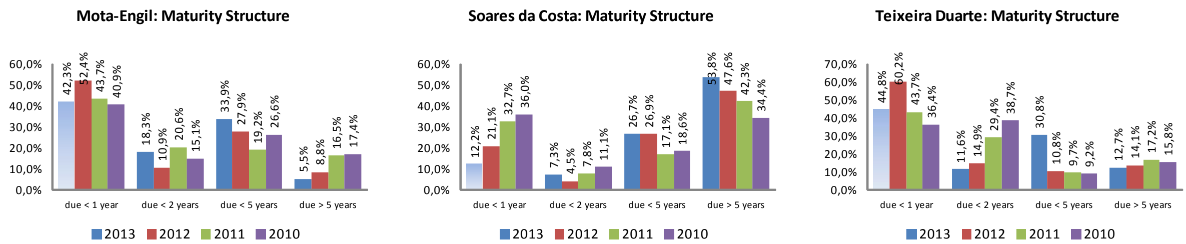
Solvability	2012				
	Non Financial Sector	Construction	by size		
			Micro	Small and Medium	Large Companies
OVERALL LIQUIDITY	116,3%	135,7%	153,0%	122,2%	125,5%
REDUCED LIQUIDITY	84,1%	75,8%	50,7%	76,2%	119,6%

Considering the high financial pressure on the construction sector, it is important to assess the ability of companies to comply with the short-term obligations: with a reduced liquidity ratio of 76% (Table 8) is a sign of a huge pressure in terms of solvability.

Another important issue is commercial credit, given its importance as a source of funding on the construction sector (15% of liabilities, but if we consider only large companies the weight rises to 27%). The sector has average collection and payment periods far superior to other sectors (especially in micro companies) and they are deteriorating (extending time) in last years. The average periods give an indication of the time delay associated with receipts and payments of debts arising from operating activities, but do not indicate the degree of indebtedness of the companies in this way. It is necessary to complement this analysis with the Net financing by commercial debt which is negative, meaning that the construction sector is not obtaining net financing via commercial credits. **Appendix 12.**

What have been the responses of large firms to this financial distress? The financial strategy to achieve a sustainable growth of the companies began by reducing the maturity of the debt (lowering the weight of short-term debt), optimization of the debt exposure to national and international banks and diversification of sources of funding (other than bank debt). In all the big companies there was a significant increase in debt maturity (Figure 3) with transfer from short term to medium and long term, hoping that increases in sales in the future will enable them to fulfill their future obligations.

Figure 3 – Maturity Structure



Source: Report and accounts 2009-2013

In respect with optimization/diversification of funding sources, Mota-Engil gave a step forward. In 2013 decided to change its corporate structure by dividing it into 3 geographical regions: Europe, Africa and South America. On the other hand, the Financial Management and Human Resources will be concentrated in Mota-Engil SGPS, leaving the operationality of the financial strategy and human resources to existing structures in each geographical area. This change from business areas (old structure was organized as business sectors) to geographical regions, was justified by the different social/legal and business context that each region is inserted in. But does not make much sense in a corporate strategy perspective, since a corporate advantage was better achieved with a business segment division than with a geographical division. The main reason behind this change is economic: Africa achieved a significant growth in recent years, among other reasons, driven by exploration and development of natural resources in the region. Mota-Engil understands that achieves greater visibility if it can show separately the African business and thereby satisfy international investors eager to specific significant investments in this region. Thus, the eventual dispersion of about 30% of the capital of this autonomous body in Africa may mean funding on better terms (higher sale price) for the Group: according to the prospectus of offer the IPO would translate into a market value of 1.06/1.33 billion pounds (€ 1,36/1,71 billion), based on 115 million shares outstanding (100%).

Thus, the new Organizational Model aims to accelerate the pace of internationalization and enhance the ability of the Group to funding abroad (this funding concern is a pressing in any organization, especially in the economic and financial situation that Portugal is facing), becoming the structure increasingly prepared for the establishment of regional companies. Since, many of the projects are abroad, ME is starting to finance itself in international institutions instead of Portuguese banks. ME creates subsidiaries abroad to be able to give assets as collaterals.

In my findings Mota-Engil and Teixeira Duarte, typically maintained lower leverage (compared with industry) on their balance sheets, controlled operating costs well, and diversified their product offerings and business geographies. Such fundamentals gave them capacity for taking advantage of opportunities and a greater degree of strategic flexibility, which became even more valuable during the recession. In addition, they were able to pay their suppliers and subcontractors faster, probably in an effort to negotiate lower prices and better service, thus rising their profitability.

Soares da Costa was a complete different story. The SdC Group is one of the largest groups of Portuguese construction sector, with over 90 years of history and over 30 years of experience in the international market, with regular activity in Portugal, Angola, Mozambique and USA. Since 2002 the activity of the Group is organized by business areas (construction, concessions, real estate and energy) with construction as the core business of the Group. The growth of international turnover (which accounted for about 57% of the portfolio in 2010, and 71% in 2013 - **Appendix 17**) and a step into diversification were not enough to offset the drop (since 2009) in turnover in Portugal. Operating margin of construction (core activity) deteriorated since 2012. In other areas of business, margins did not follow sales growth, although they were at a stable level.

The financial results have worsened since 2010, following the increasing level of indebtedness. Net bank debt has been growing over the past five years , reaching € 1 Billion in 2012 (about half of this debt relates to project finance funding) **- Appendix 9B**. The net debt (Table 6) is growing to very high levels (14,2 x EBITDA in 2012, 8,9 x EBITDA if we only account for the corporate net debt excluding the project finance debt and its EBITDA effect), both due to increasing debt and due to a drop in EBITDA.

In fact, Soares da Costa since 2008 was involved in projects of expansion (investment in Self Energy), significant projects in public-private partnerships (PPP) and organic growth, which involved much debt. Thus, the level of debt is a major constrain for the activity, Soares da Costa lost the ability to access any additional funding and to finance new works, and on the other hand, the cost of debt weighs greatly in its accounts. A recession with no ability to fund was fatal. Several investments were already been postponed (as the energy sector), in fact, the insufficient capital was threatening not only the expansions prospects but also the ongoing projects.

Soares da Costa needed an urgent corporate and financial restructuring, so the group build a strategic partnership with António Mosquito, an Angolan businessman that took a majority position in the core segment of the Group (construction), through a capital increase in the sub-holding SdC SGPS Construction in the amount of € 70 Million, equivalent to a stake of 66.7% in the capital and voting rights of SdC Construction SGPS. Soares da Costa Group now holds a minority stake in its main operation, which is the area of construction. The position at SdC SGPS Construction no longer consolidates and is classified as assets held for sale, the group become essentially a shareholdings managing type of holding, with some importance in the areas of concessions (motorways and water) and real estate.

The capital increase of € 70 million was applied in (i) the reduction of debts to suppliers (€ 40m for immediate payment to restore trust and relationship with suppliers), (ii) strengthening of working capital (€ 25m in liquidity reserve), and (iii) operational restructuring (€ 5m). There was also a financial restructuring considering a 10% haircut (about € 20,4 Million) on the debt in Portugal with CGD (€ 134,7 Million) and the Millennium bcp (€ 69 Million) and restructuring the remaining debt to 10 years with 5 years grace period (annual reimbursement from the 6th year) and a fee of interest corresponding to the 6-month Euribor plus a spread of 1.5% in the first 3 years and 3% thereafter (this last condition was extended to all other Portuguese banks).

With these changes the main advantages obtained were the strengthening in the capital structure, the enhancement of working capital, including the settlement of suppliers, the support for operational restructuring, the support for the development of the activity in the main market (Angola), and other African markets with high potential, the increased confidence on the part of the company's stakeholders (creditors, customers, suppliers, employees) and above all the continuity of operations.

In general the financial restructuring is common to all companies studied, but in different models and in different degrees. The different circumstances of each and decisions made over time allowed different degrees of freedom of action in each of them. The enormous growth of construction in Africa and the historical presence of Mota-Engil in the region was vital to its success. The huge diversification in TD over the last 20 years and the sale of Cimpor which allowed TD to reduce debt in almost half were also critical success factors. But in all these firms retrenchment is a process of survival (Gopinath, 1991) and an activity that all of them were more or less forced into due to the severity of their performance decline (Whetten, 1987; Cameron et al, 1988). Firms were forced to cost cutting measures (Hofer, 1980; Robbins and Pearce, 1992), to sell assets (Robbins and Pearce, 1992), to manage cash flows (Bibeault, 1982; Hambrick and Schecter, 1983; Sudarsanam and Lai, 2001) and to rework their capital structure.

In conclusion construction companies, in general, need a strong financial restructuring that allows them to reduce financial costs and postpone maturities of their debt (in order to relieve pressure), to restructure their debts with an haircut in many cases, and to strengthen the capital in order to capitalize. If necessary (due to cash flow needs) companies should sale assets (Robbins and Pearce, 1992) and focalize in their core activities (Boyne and Meier 2009; Robbins and Pearce, 1992; Robbins and Pearce, 1993). These findings are in line with the literature review: retrenchment is essential to any kind of turnaround process.

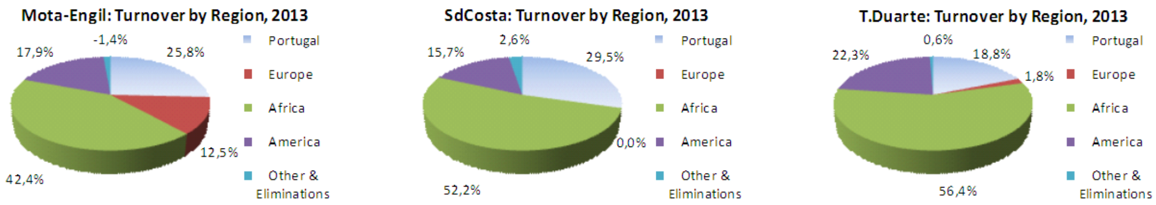
4.3. – Internationalization

The volume of international business of most of European construction companies is originated in its own region markets - Europe accounted for approximately 47.5% of the amount in question in 2011. For Portuguese companies, however, the European market accounts for only 15.6% of its turnover abroad, making Portugal, along with Germany as the country with the highest percentage of international turnover from outside Europe (about 85%). According to European International Contractors, while to the average of European construction firms Africa represents only 8.6% of its international business, for Portuguese companies represent more than 75%, revealing the importance of this market to Portugal, not replicable to any other European country. In that region, Portugal has the second largest share of the turnover of European construction companies, with more than 23%, only being surpassed by France, which assumes 29%. Also noteworthy is the strengthening of the Portuguese presence in Central and Southern America which takes the 3rd largest European involvement in the region. **Appendix 15.**

Internationalization is in fact a reality in the larger Portuguese construction companies (about 86% of the international business sector is held by the top ten), a successful process as we can verify by the average annual growth rate of 33% in the volume of international business of Portuguese companies over the period 2004-2012. The value of 2012 more than sixfold the value of 2004. New contracts standing ahead of turnover in almost every year is a clear indication of growth. **Appendix 15.**

While internal market is losing weight fast (40/50% share in 2010 to 20/30% share in 2013 - **Appendix 17**) and decreasing at a pace around -20% every year, external market (mainly Africa) is growing huge and gaining weight (on last 2 years: ME 57,4% and TD 80,2%). If was not external markets Portuguese companies would be dead already. The importance of external markets it's more in its growth and weight than in its margins (Table 9), not so different from the internal market and in some more sophisticated markets (Latin America and Europe) with lower margins due to the strong competition in those markets. Even in Africa, Portuguese companies show often noncompetitive prices against competition from China, Brazil or India, so margins tend to reduce.

Figure 4 - Turnover by region



Source: Report and accounts 2009-2013

Table 9 – ME: EBIDTA Margin by region

Mota-Engil	2013	2012	2011	2010
EBITDA Margin (EBITDA/Turnover)	15,7%	12,8%	13,6%	11,8%
Portugal	18,1%	15,2%	14,7%	11,4%
Europe	-8,6%	0,0%	4,3%	4,0%
Africa	24,2%	18,7%	17,6%	16,4%
America	8,3%	10,6%	8,6%	6,2%
External Market	14,8%	11,5%	12,5%	12,3%

Source: Report and accounts 2009-2013

The entry of Chinese construction companies in the Angolan market, boosted by strong support from the Chinese government, had natural repercussion in terms of market share. The turning point came in 2004 when the Angolan government negotiated with China a line of credit that provides that 70% of the reconstruction works are awarded to Chinese companies and only 30% remain in the hands of local construction companies. After some time, Portuguese companies were gradually regaining their space, although the Angolan market for public works remain highly competitive. Apparently, the Portuguese construction companies, especially larger ones, will not have been the most affected, given its consolidated presence in the Angolan market, the ability of communication and integration, and certain dissatisfaction with the quality of the Chinese public works (including construction materials).

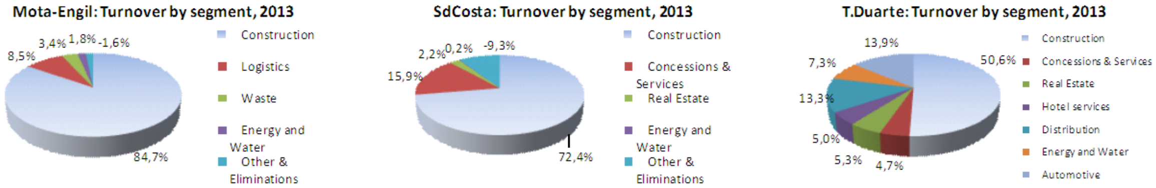
Mota-Engil has been the largest Portuguese civil and public construction contractor since the merger of Mota and Engil in 2000. It was founded in 1946 by Manuel António da Mota, and in that same year a subsidiary in Angola was also created. This historical bond with the African market would turn out to be a key strength for the group in the latest years, as Europe is facing a tough recession. In Angola, ME build a privileged strategic position over 68 years, benefiting from an important alliance with the state-owned company Sonangol. Mota-Engil is nowadays present in 19 different countries around the world. International markets now represent nearly 73,5% of the turnover of the group (Figure 4), which is very notable since construction represents 87% of the entire portfolio of activities (Figure 5). The international markets for Teixeira Duarte represents nearly 81%, but in a very diversified portfolio, where construction only weights 50%.

Companies must learn from this experience because internationalization is a way to circumvent the constraints of the internal market (dimension and current crisis) and make use of existing opportunities in targeted foreign markets (with favorable economic developments and significant investments in infrastructures and real estate). Of course there are political risks and the problem of local compulsory partnerships (often inaccessible to small companies), mainly in Africa. But that is something they have to live with, since Portuguese companies will never have dimension to enter and compete in more friendly markets (but more sophisticated and with fierce competition) like Europe and America. Large companies in Portugal have already an historical presence and experience in Africa and Latin America, so the same way in Portugal smaller firms need to joint forces with larger ones (subcontracts), these small companies can benefit from that prior special relationship and using the same strategy gain presence and market in other geographies.

4.4. – Diversification

So as to major European construction companies, also for major Portuguese companies in the sector, the internationalization and diversification of its activities has emerged as cornerstones of its evolution and as part of its strategies to ensure its sustainability and growth. The international business on major companies in the sector grew at a fairly high rate in recent years, and about 90% of those larger companies were already operating in other businesses aside from construction (more than 70% were present in the concessions and real estate, more than 50% in industry and environment and more than 40% in tourism and energy). **Appendix 19.**

Figure 4 - Turnover by segment



Source: Report and accounts 2009-2013

During the past few years, diversification into other businesses and geographies has been at the core of Mota-Engil and Teixeira Duarte group's strategies as a mean to achieve sustainable growth and a higher consolidated EBITDA margin (achieve higher margins and constant/stable cash flows).

In addition to the heavy construction core business, Mota-Engil has diversified into the industries of environment and services (E&S, including tourism, ports, logistics, energy), transport concessions (ME reorganized the transports concessions sector by transferring all the assets and concessions to a newly formed company named Ascendi Group, in which ME have a 60% equity stake) and more recently mining. Through a 37.5% stake in the Portuguese company Martifer, the company is also present in the metallic construction and alternative energy industries. However sector diversification is not very high in ME.

Construction still represents a great part in their turnover (87%), mostly due to the development of the African and Southern American construction sectors. E&S is losing weight on total turnover, because it is growing at an inferior rate than the international construction business, thus representing a minor % of the total pie. If we remove the impact of globalization, the effect of diversification would be much more visible.

By contrast, Teixeira Duarte is a very high diversified company, where construction only weights 50% and with interests in diverse areas like real estate, hotels, concessions, distribution, energy and auto. Real Estate and Hotel services with margins of more than 30% and distribution with margins above construction helped to rise overall margin of the group.

Diversification was never very high in Portuguese firms (with the exception of Teixeira-Duarte), with construction segment or related segments (concessions) accounting with more than 85% of total turnover. One reason is the rising weight of international construction segment. Other reason is the lack of human resources (management, capabilities, know-how) to diversify to other segments. With the crisis another reason arise: lack of capital (SdC in 2010 decided to diversified to the renewable energy sector due to its highly attractive historical profitability margins, but less than 2 years later the strategies guidelines were reoriented to construction sector and financial sustainability as this study shows in previous sections). However companies must learn from these experiences because diversification can ensure sustainability and growth by seizing new business opportunities and by gaining the benefits arising from synergies. Construction companies must become multi-activity firms as a way to achieve higher margins and constant/stable cash flows, a way to offset the low margins in the construction industry and fluctuations of activity that characterize it.

Diversification can be also achieved inside the construction sector, by refocusing the industry internally: change from new construction to rehabilitation and maintenance (weight of 24% against an average of 53% in Europe in 2011 - "Associação Portuguesa Construção"), which requires greater qualification of professionals and businesses. The construction sector needs to reduce quantity and increase in quality. That means less business, but better companies and higher margins.

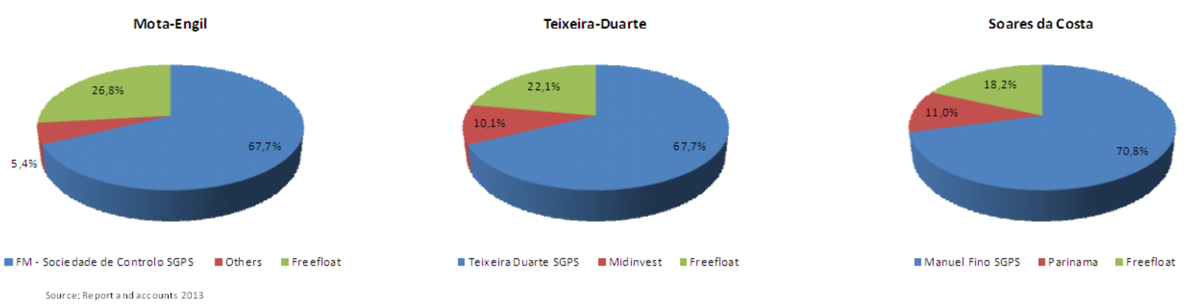
4.5. – Concentration

Table 10 - Top 50 European construction sector companies by turnover, Share by country, 2011

	Share	*Cumulative Share*	***Portugal***	*Turnover*
France	27,8%	27,8%	Mota-Engil	2.176 Millions €
Spain	21,3%	49,1%	Teixeira-Duarte	1.263 Millions €
United Kingdom	12,8%	61,9%	Soares da Costa	873 Millions €
Germany	10,9%	72,8%	***Spain***	*Turnover*
Others a)	27,2%	100,0%	ACS	28.472 Millions €
			FCC	11.755 Millions €
a) Portugal	1,4%		Ferrovial	7.446 Millions €
			Acciona	6.646 Millions €
Source: Deloitte – "European Powers of Construction, 2011"			Obrascon	4.870 Millions €

The size of Portuguese companies is relatively small compared with European firms (Table 10), as can be seen by the fact that in 2011, only three are part of the European top 50 (Source: Deloitte – "European Powers of Construction, 2011"). Also when analyzing the situation in an Iberian context it appears that Portuguese companies are regional in scope. The 2011 turnover of the three largest Portuguese companies together does not reach the volume of the fifth largest Spanish company business.

Figure 6 - Shareholder Structure, 2013



The largest construction companies in Portugal consider to be essential to promote the concentration in the sector, given that dimension is an essential support for the strengthening of the processes of internationalization and diversification. This need is recognized by the vast majority of companies, but the movement was not initiated and it is unlikely to happen quickly, given the current limited financial capacity as well as the preponderance of family management companies (Figure 6). Mota-Engil (despite being the largest in Portugal) is still very small compared to other European players. This is a major obstacle to compete in the international markets (mainly in South America and Europe) and high-scale projects. In fact, Mota-Engil, Teixeira Duarte and Soares da Costa continue to be family companies (Equity Stake around 67/70%), a situation that can be seen in similar way in southern Europe, especially in Spain.

Within the scope of consolidation in the sector, was established in March 2012, the Elevo Fund (whose shareholders are BES, BCP, CGD, MG and BANIF), which materialized the acquisition of Edifer, Monte Adriano, the Hagen and Eusébios, companies in the middle segment of the engineering and construction sector, with a total turnover that puts Elevo in the 4tht place in the national ranking of the sector.

The strategy is simple: the fund will take control of medium sized bankrupt construction companies, being responsible for its debts (redemption will include the partial debt forgiveness by the main creditor banks - CGD, BES, BCP and Banif) and enabling the immediate injection of liquidity in construction. Then will seek to gain synergies with existing assets, forming a construction company with higher competitive ability (turnover close to € 800 Million). The fund's objective is not the recovery of companies alone, but the recovery of several companies to then proceed to their merger and concentration.

Considering the low expression that the domestic market will have in the coming years, the group's strategy will boost by international expansion. This strategy will be supported primarily by the area of Construction and Engineering, which will necessarily lead to a sale or merger on operational areas that are not priorities, particularly the real estate component and the area of concessions, whose assets represent approximately € 150 million. The first priority is to generate cash flow in order to compensate and pay off the enormous debt, meaning that there is no scope for developing other areas of business that involves capital.

Part of the strategy also involves reducing human resources, since in a merger there is always redundant functions, and because the national market is shrinking, which internationalization strategy allows to counterbalance, but not enough (because some markets impose quotes for expatriates).

The Fund emerged not only as a project of sector consolidation (gain muscle and size to embrace new projects and markets) but also to decrease the exposure of banks, which through its participation in the fund, they expect to receive the values indebted. The banking sector was important in two ways. At first, funded the fund and created the conditions for a debt restructuring. In a second, created support mechanisms, such as bank guarantees and immediate liquidity injection.

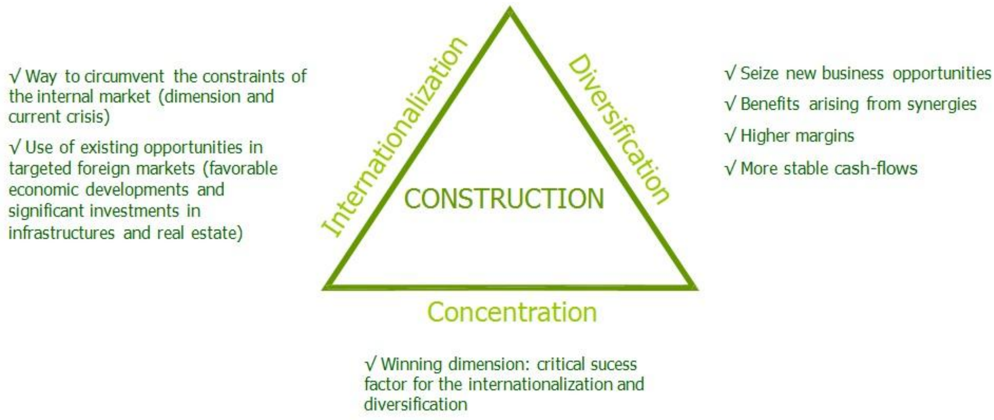
Much of the problems in the construction sector in Portugal derives from an overspray. All movements that existed to group different companies were consciously or unconsciously resisted by the sector itself. And many of these companies, when in 2011 are hit hard by the crisis, had no muscle, had no management, had no critical mass to be able to make that shift in their business angle. It's time to consolidate.

The third fundamental axis for companies in the Portuguese, namely to address the two afore mentioned, is concentration, in order to win dimension, enhance skills, increase responsiveness and relevance (at the Iberian range), to increase the capacity of risk assumption, achieve synergies and create more value.

4.6. – Strategic reorientation: synthesis

In the last sections it was analyzed 3 turnaround strategies essential to the recovery process: Internationalization, Diversification and Concentration. A more visual understanding about the strategic reorientation for construction industry this study purposes can be seen on Figure 7.

Figure 7 - Strategic Reorientation for Construction Industry



Strategic reorientation is once more in line with literature review about turnaround: those who change strategy were the winners in the long run (Filatotchev and Toms, 2006; Robbins and Pearce, 1992). But unlike what was expected, strategic reorientation was not a second step (Robbins and Pearce, 1992) but a prior decision in the most successful cases (Mota-Engil e Teixeira Duarte). Those with that lack of insight are now struggling and focused in the retrenchment stage as a prerequisite for turnaround (Filatotchev and Toms, 2006; Robbins and Pearce, 1992). In meanwhile any recovery strategy is step aside or postponed and there is no available capital to internationalization, diversification or concentration. Companies are forced to be focus in their core activities. The priority is to generate cash flows (Bibeault, 1982; Hambrick and Schecter, 1983; Sudarsanam and Lai, 2001) in order to compensate and pay off the enormous debt, meaning that there is no scope for developing other strategies that involves capital. The process will be more difficult and will take longer, but what is important is that companies must know that they must change their way of doing business.

A corporate crisis is often a sign that the company's business model has petered out and the industry's underlying structure has changed dramatically, so old ways of doing business no longer works, growth formula cannot be sustained, old pattern has been pushed to its limits and is destroying value. Portuguese construction sector is a very good living example of such a structural break and such a break means hard times and adjustments are neither easy nor quick.

5 – Conclusion: The Portuguese construction industry in turnaround

The complexity, confusion and uncertainty surrounding the global credit crisis and the global recession is so large that many companies may not survive. With contracting markets, frozen credit, high leverage and a deep economic crisis, many businesses today are fighting for their lives. Trying to save indiscriminately companies in the industry is a mistake. Portugal cannot spend more money on oxygen balloons to save archaic and unviable companies. With some exceptions, requiring the State to promote a new wave of investment in infrastructure and urban equipment, or resorting to the deviation of money of QREN from its original goals is not a good solution and hardly makes sense. The construction sector and real estate does not come out of the crisis by attracting more new construction, more urbanization and more financial resources of the State. The construction sector is an oversized sector and whose ongoing adjustments were predictable against the excesses of new construction in Portugal in the last two decades, whether of buildings or infrastructure.

The sector is bankrupting, as a whole and very quickly. Small businesses dependent on real estate were the first to stop. Then large. And among large, only two are surviving the crisis, and only one of them is a "whole" construction company - Mota-Engil -, the other is Teixeira Duarte, with less than 50% of construction in its well diversified corporate portfolio: sold Cimpor, reduce its debt, diversified itself and between Brazilian oil and Angolan supermarkets, gained a new life. From Teixeira Duarte down, doesn't left any brick. The entire construction industry can be wiped out.

Mota-Engil accounting with an extensive network of relationships (one of its main strategic resources build in decades) gained works in Portugal, Mozambique, Angola, Poland, Peru, Colombia and many others. Managers who prepare during good times can improve their companies' chances to endure or thrive in the eventual downturn.

We can find same characteristics: When entering the downturn, Mota-Engil and Teixeira Duarte typically maintained lower leverage on their balance sheets, controlled operating costs well, and diversified their product offerings and business geographies. Such fundamentals gave them a greater degree of strategic flexibility, which became even more valuable during the recession.

Below the two largest, is the impending disaster. Soares da Costa was with no funding and waiting to know their fate until the António Mosquito solution. And one day the entire construction segment might be out of the group and no longer a Portuguese company.

Somague is submerged in problems. Lena, Abrantina, Opway, FDO are in line behind Edifer. Here comes the Vallis, the fund that absorbed Edifer, Monte Adriano, Hagen and Eusébios and is studying other distressed companies for additional mergers. A fund that aims to make a controlled dissolution of companies: shareholders lose everything, debt is negotiated with banks and save what is possible to save.

This is a time of unprecedented opportunity to rethink offerings, markets, business processes, and organizational structure and to improve them to achieve growth. Success will depend on leaders who are able to stabilize the company as they identify and exploit opportunities, find new market, create innovative new offerings, and restructure and reposition. Even leaders who need to make very deep cuts can think strategically about where the business will be and how they might build for the future. It is in this scenario that this study presents solutions to the survival and revival of the construction sector: **Retrenchment** (financial Restructuration, asset retrenchment, operating efficiency) ; **Diversification** ; **Internationalization** ; and **Concentration**.

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